

DIRECT TESTIMONY

OF

ROBERT KOCH

TELECOMMUNICATIONS DIVISION

ILLINOIS COMMERCE COMMISSION

AMERITECH ILLINOIS

DOCKET NOS. 98-0252/0335 (CONSOL.)

NOVEMBER 3, 2000

Table of Contents

I. INTRODUCTION.....	1
A. WITNESS IDENTIFICATION AND QUALIFICATIONS	1
B. PURPOSE OF THIS TESTIMONY.....	4
II. AMERITECH’S PRICE CAP PLAN	6
III. THE PERFORMANCE OF THE PLAN	11
A. THE COMMISSION’S REQUIRED ITEMS FOR REVIEW OF THE SERVICE BASKETS	11
B. PROBLEMS CONCERNING THE ANNUAL FILINGS	16
C. PROBLEMS WITH THE STRUCTURE OF THE SERVICE BASKETS.....	20
D. THE IMPACT OF COMPETITIVE RECLASSIFICATION	26
VI. AMERITECH’S RECOMMENDED CHANGES TO THE SERVICE BASKETS.....	30
VI. STAFF RECOMMENDATION	37
VI. CONCLUSION	42

Staff Attachment 13.01 – Performance of the Service Baskets

Staff Attachment 13.02 – Calculation of Ameritech’s Combined API

1 **I. Introduction**

2 **A. Witness Identification and Qualifications**

3

4 **Q. Please state your name and business address.**

5

6 A. My name is Robert F. Koch and my business address is 527 East Capitol Avenue,
7 Springfield, Illinois 62701.

8

9 **Q. By whom are you employed and in what capacity?**

10

11 A. I am employed by the Illinois Commerce Commission ("Commission") as an
12 Economic Analyst in the Rates Section of the Telecommunications Division.

13

14 **Q. Please Describe your educational and occupational background.**

15

16 A. I received a Bachelor of Science degree in Mathematics and Economics from
17 Illinois State University in 1992. In May of 1997 I received a Master of Science
18 degree in Economics from Illinois State University. During the Summer of 1996, I
19 worked as an intern with Telecommunications Rates Section of the Public Utilities
20 Division with the Commission. Upon graduation, I accepted a position with the
21 Commission as an Economic Analyst in the Rates Section of the
22 Telecommunications Division.

23

24 **Q. Please briefly describe your duties with the Illinois Commerce Commission.**

25

26 A. My responsibilities include reviewing wholesale and retail tariff filings of both
27 competitive and non-competitive telecommunications services, providing support to
28 other Commission Staff, and analyzing cost study issues in docketed cases that
29 have cost of service and rate implications. I am also responsible for reviewing the
30 managerial, technical, and financial capabilities of companies seeking approval to
31 do business in Illinois as competitive local exchange carriers.

32

33 **Q Have you previously testified before the Commission?**

34

35 A. Yes. I have provided expert witness testimony in several docketed cases: I.C.C.
36 Docket No. 96-0503 (GTE wholesale rate docket); I.C.C. Docket Nos. 97-
37 0601/0602/0536 (Consol.)(access charge reform, etc.); I.C.C. Docket No. 97-0633
38 (interim local number portability cost recovery); I.C.C. Docket No. 98-0200/0537
39 (complaint investigating GTE Usage Sensitive Service rates); I.C.C. Docket No. 98-
40 0860 (Ameritech competitive service reclassification); I.C.C. Docket Nos. 99-
41 0038/0039 (Consol.) (access charge refunds for IXC's); I.C.C. Docket No. 99-0185
42 (Ameritech alternative regulation Annual Filing); I.C.C. Docket No. 99-0412
43 (Geneseo EAS petition); I.C.C. Docket No. 99-0544 (ATS Services certification
44 case); I.C.C. Docket No. 00-0043 (Cub complaint of Ameritech usage plans); I.C.C.

Docket No. 00-0187 (GTE sale of assets to Citizens Telecommunications Company of Illinois); I.C.C. Docket No. 00-0023 (complaint investigating Ameritech's termination penalties); I.C.C. Docket No. 00-0233 (Universal Service for rural carriers); and I.C.C. Docket No. 00-0393 (investigation of Ameritech's line sharing tariff).

Q. Do you have any experience directly related to the issues in this proceeding?

A. Yes. I have been directly involved in the review of Ameritech Illinois' ("AI" or "the Company") last three annual filings for its alternative regulation plan ("price cap plan"), and in the preparation of Staff's comments in the compliance dockets for these filings. As a result, I am familiar with the manner in which the alternative regulation plan has functioned and the Staff's concerns regarding its functioning. Further, as an employee of the Rates Section of the Telecommunications Division, I have been involved in the review of tariff filings affecting AI's alternative regulation plan. Finally, to the extent that service reclassification is an issue in this docket, my experience as a Staff witness in ICC Docket No. 98-0860 is relevant.

B. Purpose of this Testimony

Q. What is the purpose of your direct testimony?

A. AI's alternative regulation plan was established in the Order in Docket Nos. 92-0448/0239 (Consolidated) ("Alt. Reg. Order"). This proceeding is in response to a requirement of Appendix A of the Alt. Reg. Order requiring the review of the plan. My testimony assesses the actual performance of the price cap mechanism since its inception. I address proposed changes to the price cap plan by AI and propose my own alterations.

Q. How is your testimony structured?

A. This testimony is divided into six sections. Section I is an introduction to my testimony. Section II describes AI's price cap mechanism in detail. Section III discusses the performance of the plan since its inception. The Commission enumerated ten issues for review of the plan in Appendix A of the Alt. Reg. Order. This section will specifically examine issues 5 through 8 of the Appendix. As part of this discussion, problems encountered by Staff in the annual filings as well as the ability of the plan to reduce rates will be addressed. Section IV examines the changes to the plan proposed by AI in this docket. I will show that the recommendations made by AI witnesses will have a significant negative effect on

85 residential customers and the Commission's ability to regulate noncompetitive
86 services on a going-forward basis. Section V provides my recommended changes
87 to the plan on a going-forward basis. I will show that some relatively simple changes
88 to the plan can remedy the defects in the plan and improve it's ability to facilitate the
89 transition to competition in the telecommunications industry. Section VI is a
90 summary of the key findings addressed in my testimony.

91 **II. Ameritech's Price Cap Plan**

92
93 **Q. Please give a brief description of how AI's alternative form of regulation**
94 **functions.**

95
96 A. Historically, the rates of AI's noncompetitive services have been governed by a
97 traditional rate of return form of regulation. The Commission Order approving the
98 alternative regulation plan placed AI under a form of performance based regulation.
99 The alternative regulation plan ties rates for noncompetitive services to a price cap
100 index and, thereby, supplants rate of return regulation with a more streamlined
101 process within which price changes can be approved. This process, as it is applied
102 to AI, consists of an annual filing made by the Company on or before April 1 of each
103 year and the subsequent approval by the Commission of the proposed price cap
104 index ("PCI"), to be effective on July 1 of the same year. The PCI is primarily based
105 upon inflation, but includes offsets for productivity, the Company's quality of service,
106 and exogenous factors that are beyond the control of the Company. The
107 Commission's decision to approve tariff changes within the annual filings is
108 determined based upon the appropriateness of the Company's proposed PCI for
109 the upcoming year as well as other parameters of the price cap mechanism.

110
111 **Q. How is the reasonableness of price changes in the price cap plan**
112 **determined in the annual filings?**

113

114 A. The reasonableness of price changes is determined through the use of service
115 baskets. AI's noncompetitive services have, for the purpose of price cap regulation,
116 been separated and placed into four distinct customer groups, or service baskets:
117 (1) Residential Basket, (2) Business Basket, (3) Carrier Basket, and (4) Other
118 Services Basket. The prices for the services within each of these baskets are
119 allowed to fluctuate over time such that each basket's Actual Price Index ("API")
120 never exceeds the PCI. As described in the Alt. Reg. Order, "the reasonableness of
121 price changes under the plan is determined by a comparison of the PCI applicable
122 to a given year and the API for each of the four customer categories." (Alt. Reg.
123 Order, Appendix A at 3).

124

125 Specifically, each basket's API must be less than or equal to the PCI at all times.
126 This requirement has implicitly placed the emphasis of the Company's annual filings
127 on the calculation of the PCI and the justification of each of its inputs. In addition to
128 whether the baskets' APIs are less than the PCI, the Commission must also ensure
129 that any proposed tariff changes are consistent with the requirements of the Public
130 Utilities Act ("PUA" or "Act"), including Sections 13-505.1 (imputation requirements)
131 and 13-507 (cost of service requirements).

132

133 **Q. Are any of AI's noncompetitive services not part of the Company's price cap**
134 **plan?**

A. Yes. As a general rule, all noncompetitive services are part of the price cap plan. However, Staff notes that all new non-competitive services are excluded from Ameritech Illinois' Alternative Regulation Plan for one year. Further, in its Order in Docket Nos. 96-0486/0569 (Consol.) ("TELRIC proceeding"), the Commission concluded that, at the present time, AI's unbundled network elements ("UNEs"), interconnection and transport and termination rates should be excluded from the alternative regulation plan currently applicable to the Company's noncompetitive services. A detailed discussion of the Commission's decision on this issue can be found in the Order in the TELRIC proceeding at page 87.

Q. Please describe the manner in which the PCI is developed.

A. At the outset of the plan, the PCI was set equal to 100. Pursuant to the Commission's Alt. Reg. Order, the PCI must be recalculated once each year according to the following formula:

$$PCI_t = PCI_{t-1} [1 + (\% \text{ change in the GDPPI})/100 - .043 + Z + Q]$$

where:

PCI_t = price cap index for current year,

PCI_{t-1} = price cap index for previous year,

GDPPI = Gross Domestic Product Price Index,

Z = exogenous change factor, and

Q = quality of service component, which is negative.

The .043 factor in the above formula represents the productivity offset that has been built into the formula. The productivity factor does not change from year to year, unlike the other factors in the formula. The factor that is most variable from year to year is the factor for inflation. Inflation is accounted for in the formula by the use of the Gross Domestic Product Price Index ("GDPPI"), which is a measure published annually by the Bureau of Economic Analysis ("BEA") of the U.S. Department of Commerce. Holding all other factors equal, economy wide inflation (as reflected in a positive value for the percentage change in GDPPI) will have the effect of increasing the PCI and ultimately allowing AI to increase rates.

Q. Could you elaborate on how the API is developed?

A. Yes. The API of each of the service baskets was set at 100 at the outset of the plan. Each basket's API is nothing more than a reflection of the basket's average price once demand and any proposed tariff changes are properly taken into account. The API is recalculated with every annual filing. The API will also change during the year at any time price changes are made to services in a basket. (Alt. Reg. Order, Appendix A at 3). The API for an individual basket is calculated as follows:

$$API = API_{t-1} * \sum_{i=1}^n v_i \frac{P_i(t)}{P_i(t-1)}$$

where:

API_t = actual price index for the current year,

API_{t-1} = actual price index for the previous year,

i = rate element i ,

$P_i(t)$ = proposed price for the i_{th} element,

$P_i(t-1)$ = current price for i_{th} element, and

v_i = revenue weight for i_{th} element.

Since the Company uses the previous year's demand to calculate the revenue under the proposed prices and under the current prices, this formula can be simplified for the calculation of the current year API as such:

$$API = API_{t-1} * \frac{PROPOSED REVENUE}{CURRENT REVENUE}$$

III. The Performance of the Plan

A. The Commission's Required Items for Review of the Service Baskets

Q. What issues pertaining to the service baskets need to be reviewed?

A. Staff witness Jeffrey Hoagg provides in his direct testimony in this proceeding, Staff Exhibit 1.0, an overview of the ten issues which the Commission specifically directed be reviewed in this proceedings, as set forth in Appendix A of the Alt. Reg. Order. Issues 5-8 of the Appendix concern the performance and structure of the service baskets, and specifically require AI to provide several listings of services which have undergone certain substantive changes during the life of the plan. This section of my testimony discusses these issues and AI's response to them. These issues are as follows:

Issue 5 A listing of all services in each basket and a report of the cumulative percentage changes in prices for each service during the period the price cap mechanism has been in effect.

Issue 6 A listing of any services which have been withdrawn during the period.

Issue 7 A listing of all services which have been reclassified as competitive or noncompetitive during the period.

Issue 8 A summary of new services which have been introduced during the period.

212 **Q. How has AI responded to Issue 5?**

213

214 A. AI witness David Gebhardt responds to Issue 5 in his direct testimony. (Ameritech
215 Illinois Exhibit 1.0 at 13-14). The list of services that have undergone price changes
216 is included as Schedule 1 to his direct testimony. Mr. Gebhardt states that, in
217 general, the Company has targeted reductions to services where demand growth
218 would be stimulated. (Ameritech Illinois Exhibit 1.0 at 14). In my opinion, Mr.
219 Gebhardt's characterizations concerning price changes and the figures in Schedule
220 1 are accurate.

221

222 My only concern with AI's choice of price reductions is in the impact it has had on
223 total revenues. As Mr. Gebhardt has stated, the Company has chosen to decrease
224 rates for services for which a change in price would stimulate demand. The
225 Company has every right to do so under the plan. The problem lies in the revenue
226 reduction calculations provided by the Company in its annual filings. The Company
227 credits the plan with reducing revenues by as much as the rate reductions times the
228 demand for the previous year.

229

230 In his supplemental direct testimony, Mr. Gebhardt calculates that the cumulative
231 annual rate reductions over the entire period of the plan have been \$301 million.
232 (Ameritech Illinois Exhibit 1.1 at 13). The annual reduction calculation appears to
233 use the correct revenue decreases reported in the six annual filings. However, this

234 calculation may overstate actual revenue reductions because it does not take into
235 consideration the impact of demand stimulation. It is logical to assume that, as
236 rates for any given services are lowered, consumers purchase more of those
237 services. However, this calculation assumes that the quantity purchased remains
238 constant.

239
240 Mr. Gebhardt also calculated that the total benefit to customers was \$943 million
241 through the end of 1999. (Ameritech Illinois Exhibit 1.1 at 13). I was unable to verify
242 Mr. Gebhardt's calculation of this figure. I requested all the calculations and
243 assumptions used to develop this figure in Staff Data Request RFK 1 but did not
244 receive an adequate response. Nonetheless, I suspect that this calculation is
245 understated due to demand stimulation affects similar to the cumulative annual
246 benefits calculation.

247
248 **Q. How has AI responded to Issue 6?**

249
250 A. AI witness Gebhardt responds to Issue 6 in his direct testimony. (Ameritech Illinois
251 Exhibit 1.0 at 14-15). The list of services withdrawn or grandfathered is included as
252 Schedule 2 to his direct testimony. To my knowledge, the list in Schedule 2 is
253 accurate. The Commission has approved each of the grandfathering or withdrawal
254 of services listed in Schedule 2. I do not have any concerns in regard to Issue 6 or
255 AI's response to this issue.

256

257 **Q. How has AI responded to Issue 7?**

258

259 A. AI witness Gebhardt responds to Issue 7 in his direct testimony. (Ameritech Illinois
260 Exhibit 1.0 at 15-17). The list of reclassified services is included as Schedule 3 to
261 his direct testimony. Mr. Gebhardt states that this schedule demonstrates that a
262 significant number of services are available from multiple providers in AI's service
263 territory. (Id. at 15). Mr. Gebhardt also states that the impact of these
264 reclassifications on the services remaining in the basket were appropriate. (Id. at
265 16).

266

267 Although I believe that the list in Schedule 3 accurately lists the services that were
268 reclassified, I have significant concerns regarding his characterization of these
269 reclassifications. First, Schedule 3 does not demonstrate that a significant number
270 of services are available from multiple providers in AI's service territory. This
271 schedule is merely a list and does not supply information regarding whether
272 competitive alternatives to the reclassified services are available. In fact, the
273 reclassification of the services listed in Schedule 3 for 1998 are under investigation
274 in ICC Docket No. 98-0860. Additionally, if the Commission rules that these
275 services have been reclassified improperly, I believe it would be necessary to
276 investigate other reclassified services.

277

278 Second, Mr. Gebhardt's assertion that the impact of reclassification has been
279 appropriate is not backed by any numerical support. Mr. Gebhardt justifies this
280 assertion because (a) this result is consistent with the statutory requirements of
281 Section 13-506.1 of the PUA; (b) the marketplace determines just and reasonable
282 rates for services; and (c) there is no economic rationale that would justify applying
283 price regulation to competitive services. (Ameritech Illinois Exhibit 1.0 at 16-17).
284 None of these assertions concern the impact on services remaining in the plan;
285 rather, they constitute nothing more than a justification for services *being removed*
286 from the plan. I have provided an analysis of the impact of competitive
287 reclassification on services remaining in the basket in subsection D of this Section
288 of my testimony, which I believe provides a more accurate and meaningful
289 assessment than Mr. Gebhardt's assertions.

290
291 **Q. How has AI responded to Issue 8?**

292
293 **A.** AI witness Gebhardt responds to Issue 8 in his direct testimony. (Ameritech Illinois
294 Exhibit 1.0 at 17-18). The list of new services is included as Schedule 4 to his
295 direct testimony. Mr. Gebhardt claims that new services are producing \$200 million
296 in annual revenue. (Id. at 18).

297
298 My only significant concern regarding this issue is in AI's classification of residence
299 local call plans as new services in Schedule 4. As I will discuss more thoroughly in

subsection C of this Section, these call plans are not new services, and their inclusion in the Other Services Basket has been harmful to consumers. AI realizes over \$ [REDACTED] in revenue through the sale of these local call plans. This is not new revenue, but rather it is revenue that has been shifted from the previously existing Band A, B, and C usage services. Although Mr. Gebhardt does not explain how he calculated this figure, it appears that this \$ [REDACTED] in revenue is part of the \$200 million in annual revenue that Mr. Gebhardt claims is from new services.

B. Problems Concerning the Annual Filings

Q. Did Staff discover significant problems associated with the annual filings?

A. Yes. As one might expect, the values for the various components of the PCI formula were contested each year. Consequently, weaknesses in the plan were exposed in the review of the annual filings. The next few questions address the problems discovered in the annual filings.

Q. Please comment on Q, the service quality component of the formula.

A. Historically, Staff has not challenged the figures provided by AI in support of the service quality component of the formula in annual filings. Staff tracks numbers provided by AI for service quality on an on-going basis and has not discovered

inconsistencies between its own records and the numbers provided by AI for service quality in the annual filing. Therefore, the “Q” factor has not been an issue in the annual filings. However, recent events have caused Staff to question AI’s reports relating to service quality

On August 11, The Citizens Utility Board (“CUB”) filed a Verified Request for Investigation into the practices of AI regarding service quality standards. Specifically, CUB seeks an investigation by the Commission into AI’s reporting of its “lines out of service greater than 24 hours” and “installation within 5 days” standards. If the allegations made by CUB are correct, the implication within the price cap plan is that approximately \$ [REDACTED] in annual revenue reductions have been inappropriately denied to ratepayers. Staff witnesses Sam McClerren (Staff Exhibit 8.0) and Cindy Jackson (Staff Exhibit 9.0) will discuss issues concerning quality of service further in their respective testimonies to this docket.

Q. Please describe the calculation of the \$ [REDACTED] in annual revenue reduction that may have been inappropriately denied to ratepayers.

A. This \$ [REDACTED] figure was developed as follows. The Company receives a penalty of .025 reduction in the PCI for not meeting a specific service quality benchmarks. The impact to ratepayers of reducing the PCI by an additional .025 is developed by examining the difference between the actual rate reductions in any

given year and the rate reductions that would have been required in service baskets if the service quality benchmarks were not met. The result of missing one benchmark in the 2000 Annual Filing is \$ [REDACTED]. The \$ [REDACTED] figure is the product of missing two benchmarks.

Q. Have there been problems concerning the GDPPI in the annual filings?

A. Yes. First, the GDPPI has come into question in past annual filings due to the restatement in GDPPI data that occurs throughout a given year. The BEA periodically revises the GDPPI data with an annual revision occurring in August of each year. The GDPPI data that is used in a given annual filing may be restated and thus, be different from the GDPPI data used in the subsequent annual filing. For example, in AI's Fourth Annual Filing, it reported the 1997 4th quarter GDPPI to be 114.4. However, in the Fifth Annual Filing, AI reported the 1997 4th quarter GDPPI to be 113.4. This difference is due to the restatement of the GDPPI data that occurred in the time between the Fourth and Fifth Annual Filings. This restatement allowed AI to double-count 0.9% in inflationary change between these two filings. Staff showed in ICC Docket 99-0185 that utilizing inconsistent GDPPI data in the Fifth Annual Filing cost Illinois ratepayers \$ [REDACTED] in rate reductions in 1999. As with AI's calculation of cumulative savings for rate changes actually made in the plan, the impact of missing these rate reductions in one year has a cumulative effect in successive years.

Second, changes that have occurred to the GDPPI benchmark have made it impossible to draw inferences on the behavior of the GDPPI over time. A benchmark change occurred in the time between the First Annual Filing and the Second Annual Filing. Whereas 1987 was the benchmark for GDPPI data used in the First Annual Filing, the benchmark for the Second Annual Filing is 1992. This explains the drastic change to the 1994 4th quarter GDPPI reported by the Company from 130.3 in the First Annual Filing to 106.1 in the Second Annual Filing. A bench mark change also occurred in the time between the Fifth Annual Filing and the Sixth Annual Filing. Whereas 1992 was the benchmark for GDPPI data used in the Fifth Annual Filing, the benchmark for the Sixth Annual Filing is 1996. This explains the drastic change to the 1998 4th quarter GDPPI reported by the Company from 115.0 in the Fifth Annual Filing to 103.9 in the Sixth Annual Filing. These two examples show that the benchmark changes have a drastic effect on GDPPI data and their consistency from year to year.

Q. Please comment on the exogenous change factor claims of the Company in its annual filings.

A. The exogenous change factor has not had a significant impact on the PCI formula in the annual filings to date. The Company has requested exogenous change treatment for certain events in four previous annual filings. However, the only time

the Commission approved an exogenous change was in the 1998 Annual Filing, when this factor had the effect of lowering the PCI. (Ameritech Illinois Exhibit 1.1 at 35). Staff is not concerned with the performance of this factor, as it appears to be behaving as intended. Staff witness Genio Staranzack discusses the exogenous change factor in more depth in his direct testimony, Staff Exhibit 2.0.

C. Problems with the Structure of the Service Baskets

Q. Please discuss the effectiveness of the price cap plan in reducing rates since its inception.

A. The plan has worked fairly effectively to reduce rates for noncompetitive services since the first Annual Filing in 1995. The performance of the price cap plan is summarized in Attachment 13.01 to Staff Exhibit 13.0. This attachment lists the total revenue and API for each service basket, as well as the PCI, for the price cap plan over its first six years. In my opinion, the Commission should consider the following facts:

At the outset, \$ [REDACTED] in revenue was subject to the plan; by the most recent annual filing, this had been reduced to \$ [REDACTED] in revenue.

The Carrier Basket has been unable to affect rate changes, starting with the 1998 Annual Filing. This is reflected by the Current API value in the table being well below the PCI for each annual filing since 1998.

Q. Do you have concerns with the changes in the Carrier Basket that have occurred over the last six years?

A. Yes. First, the API for the Carrier Basket has become so small that the Commission has been unable to require rate reductions for this basket since the 1997 Annual Filing. This is mainly the result of significant access charge reform at both the Federal and State level since 1997. These reforms have significantly reduced the access charges and subsequently reduced the API for the Carrier Basket significantly. Concurrently, the introduction of wholesale rates to the Carrier Basket during 1996 has steadily increased the level of revenue in this basket.

Second, access charges are regulated outside of this plan, and cause volatility within the Carrier Basket. Access charges are determined either through the mirroring of federal rates or through cost studies as ordered in ICC Docket Nos. 97-0601/0602 (Consol.). Although access charges are technically in the price cap plan, the plan does not affect rates for these services in any way. Rather, changes to federal access charges impact the Carrier Basket significantly, as the first concern in this discussion has illustrated. On a going-forward basis, any changes to cost studies that cause access charges to fluctuate will also affect the Carrier Basket.

To mitigate these concerns, I recommend that access charges be removed from the plan, starting with the 2001 filing. Further, I propose to move the remaining services in the Carrier Basket to the Other Services Basket. The Carrier Basket would then be removed from the price cap plan.

Q. Do you have concerns with the changes in the Business Basket that have occurred over the last six years?

A. Yes. Revenue in the Business Basket has decreased from \$[REDACTED] in 1996 to \$[REDACTED] in 2000. This is in large measure the result of the competitive reclassification of a significant number of services between the 1997 and 1998 Annual Filings. A significant part of this reclassification occurred in two tariff filings that are currently being litigated in ICC Docket No. 98-0860. The Business Basket now consists mainly of coin operated pay telephone (or "COPTS") services. The logic used in creating the Business Basket was to insure that this class of customers would not be discriminated against in terms of rate reductions in the annual filings. Since COPTS services are effectively a specialized subset of business services, it is not necessary to maintain the Business Basket to protect the subset of business customers purchasing these services against discrimination.

If the Commission accepts Staff's recommendation in ICC Docket No. 98-0860, the majority of the reclassified business services would again be declared

noncompetitive and would therefore be returned to the Business Basket. The Business Basket would again have a significant amount of services and revenues. However, if the Commission chooses to maintain the competitive classification of these services, there would be no compelling reason to maintain the Business Basket. For administrative ease, as well as increased pricing flexibility, moving COPTS services to the Other Services Basket would be more appropriate than maintaining the basket.

Q. Do you have concerns with the changes in the Residential and Other Services Baskets that have occurred over the last six years?

A. Yes. I am concerned with the transfer of revenue from the Residential Basket to the Other Services Basket resulting from customers subscribing to local usage plans. The current basket structure is such that ordinary Band A and Band B usage falls into the Residential Basket for residential customers, while residence "5&5" and "call pack" local usage plans fall into the Other Services Basket. The 5&5 plan offers customers Band A calls at 5 cents a call, while charging 5 cents a minute for Band B and Band C calls. The call pack plans offers customers a specific number of Band A, Band B, and Band C calls per month for a flat rate. For example, the call pack 100 offers the customer 100 calls for \$10 per month. Both of these plans are targeted to users with high Band C usage. The revenue in these call plans was minimal at the time that they were introduced into the Other Services Basket.

498 However, beginning with the 1998 Annual Filing, the revenue in residence call plans
499 has become increasingly significant. In the year 2000 Annual Filing, the revenue for
500 residence call plans equaled \$ [REDACTED].

501
502 Revenue realized from residential call plans properly belongs in the Residential
503 Basket. As calling plans become more attractive relative to the regular usage rate,
504 residence usage revenue shifts from the Residential Basket to the Other Services
505 Basket. This is a problem because shifting what is clearly residential service
506 revenue to the Other Services Basket compromises the ability of the price cap plan
507 to guarantee reductions in rates for residential services. The Commission
508 established the Residential Basket to limit the likelihood of discrimination against
509 this customer class. Substantial transfers of revenue to the Other Services Basket
510 will result in rate reductions in the Other Services Basket, but there is no guarantee
511 that the Company will choose to include the residence calling plans in these
512 reductions. In fact, there have been no reductions for either the 5&5 or the call pack
513 plans in any of the annual filings since they have been introduced.

514
515 The remedy to this problem is to relocate the residence local call plans from the
516 Other Services Basket to the Residential Basket. This is easily accomplished, and
517 will reestablish the protections that were initially envisioned for residential
518 customers.

520 **Q. Do you know of any reasonable justification for placing residence call plans**
521 **in the Other Services Basket?**

522

523 A. The only reason that I am aware of for placing residence call plans in the Other
524 Services Basket is that the call plans represent new services, and new services are
525 best put in the Other Services Basket. I have two objections to this rationale. First,
526 the call plans are not new services at all. These plans consist only of Band A, Band
527 B and Band C usage. Second, even if the Commission determined that these are
528 new services, it is still not clear that the services belong in the Other Services
529 Basket. In fact, it is quite consistent with prior Commission actions to assign new
530 services to baskets other than the Other Services Basket. For example, wholesale
531 services were deemed new services and ordered into the Carrier Basket in ICC
532 Docket Nos. 95-0458/0531 (Consol.).

533

534 **D. The Impact of Competitive Reclassification**

535

536 **Q. Has service reclassification reduced the effectiveness of the plan?**

537

538 A. Yes. The most significant impact of service reclassification is the reduced ability of
539 the price cap plan to regulate rates. Even if it were determined that all service
540 reclassifications to date are proper, the fact remains that the price cap plan has
541 been weakened considerably as a result.

Improperly classifying services as competitive causes harm to consumers in two ways. First, AI is no longer required under the plan to reduce rates for the services that are reclassified as competitive, as it is for noncompetitive services that remain subject to the plan. Second, the Company has an incentive to increase rates for improperly classified services. Demand for noncompetitive services generally is inelastic, and as such the Company can increase rates to a level that maximizes profit without fear of losing customers. The discussion in the next two questions illustrates the significance of service reclassification on the plan.

Q. What has been the impact on the Residential Basket as a result of service reclassification?

A. The impact of reclassifying services in the Residential Basket is captured in the table below. The table shows the revenue for services that were reclassified out of the Residence Basket over the course of the plan. The table bifurcates the impact of reclassification, showing the effect of reclassifying Band C usage in noncompetitive exchanges and the effect of reclassifying access lines in certain Access Area C exchanges. The table illustrates that the reclassification of Band C usage has yielded the most significant impact. The revenues for Band C usage in this table take into account the steadily increasing rates for the service. The impact of network access line reclassification was not as dramatic as for Band C usage,

but is also rather significant. The total amount of annual revenue removed from the Residential Basket has increased substantially to \$[REDACTED] in 2000. This is revenue that would have been eligible for rate reduction in annual filings if it had not been reclassified.

I have estimated the amount of revenue reductions that would have occurred without service reclassification by multiplying the actual percentage decrease in the API for each year to the revenue for all reclassified services in each year. These estimates reflect rate increases that would not have occurred if the services were not reclassified. Therefore, these are only approximate estimates of revenue lost due to reclassification. The estimates below show that AI customers have paid \$[REDACTED] in higher rates as a result of competitive reclassification in the Residential Basket between 1996 and 2000.

Revenue for Services Removed from the Residential Basket

	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>Total</u>
From Comp. Exchanges						
Access Line Revenue			[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Usage Revenue			[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
From Noncomp. Exchanges						
Band C Usage Revenue	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
% Change in API	1.9083%	2.4397%	2.0041%	3.1329%	2.2776%	
Unrealized Savings	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

578

579

580 **Q. What has been the impact on the Business Basket as a result of service**
581 **reclassification?**

582

583 A. Reclassification has reduced the Business Basket significantly over the course of
584 the price cap plan. This is most visibly seen in Attachment 13.01 to Staff Exhibit
585 13.0, where the amount of revenue (Current) decreased from \$[REDACTED] to
586 \$[REDACTED] between the 1997 and 1998 Annual Filings. That loss can be almost
587 entirely attributed to competitive reclassification and represents more than a 94%
588 decrease in the value of the Business Basket. I have been unable to develop the
589 total impact of reclassification in the Business Basket due to a lack of available
590 data. I have sent a late data request (Staff Data Request RFK 5) to the Company
591 seeking this additional information, and will hopefully be able to provide a more
592 complete analysis of the impact of reclassification in the Business Basket in my
593 Rebuttal Testimony to this docket.

594 **VI. Ameritech's Recommended Changes to the Service Baskets**

595

596 **Q. Please comment on changes to the service baskets as proposed by the**
597 **Company.**

598

599 A. AI witnesses Gebhardt, Harris, and Larkin each discuss recommended changes to
600 the service baskets in their direct (and supplemental) testimony. However, I believe
601 the most comprehensive list of AI's proposals concerning service baskets is found
602 in Schedule 1 to Ameritech Illinois Exhibit 3.0. This schedule is a redlined version of
603 Appendix A of the Alt. Reg. Order. The remaining questions and answers in this
604 section of my testimony address recommended changes found in Schedule 1, as
605 they pertain to service baskets.

606

607 **Q. How does AI propose to alter its service baskets?**

608

609 A. AI wants to alter its service baskets as follows:

610 ?? Remove all access charges and resold services from the plan.

611 ?? Combine the remainder of the services currently in the plan into one basket.

612 ?? Allow pricing flexibility of 15% on all services in the plan.

613

614 **Q. Should the Commission adopt AI's proposal to remove access charges and**
615 **resold services from the plan?**

616

617 A. Not entirely. As was mentioned previously in my testimony, I also recommend that
618 access charges be removed from the price cap plan. However, consumers can still
619 benefit from wholesale services being in the price cap plan. I see no reason why the
620 Commission would remove these services from the plan. As they are currently
621 placed in the Carrier Basket, there have been minimal rate reductions for wholesale
622 services in the plan, nor have they been able to affect rate changes for any other
623 services in the Carrier Basket due to the small API for the basket. However, if
624 wholesale services were placed in the Other Services Basket, where the API is
625 close to the PCI currently, benefits to consumers and resale competitors would be
626 possible. Moving wholesale services to the Other Services Basket would increase
627 the amount of revenue in the Other Services Basket by \$ [REDACTED] annually.

628

629 **Q. Should the Commission adopt AI's proposal to combine all the remaining**
630 **services in the plan into one basket?**

631

632 A. No. The Commission had significant reasons to segregate the noncompetitive
633 services into four baskets at the onset of the plan. First, there is potential for
634 customer classes to be discriminated against as a result of shifting rates within a
635 basket. The Commission recognized in the Alt. Reg. Order that residential services
636 are less elastic than other services. Protection for residential customers against
637 this type of discrimination was built into the price cap plan by creating a separate

638 basket. Second, if wholesale services and access charges were a part of the
639 combined basket, there would be the potential hazard that changes affecting one
640 type of service would have an inappropriate impact on all services in the plan.
641 Therefore, I will propose a two-basket system in Section V of my testimony that
642 protects residential customers yet gives the Company more flexibility for rate
643 changes than is available under the current plan.

644
645 **Q. Do you have concerns with AI's calculation of the API for a single service**
646 **basket?**

647
648 A. Yes. AI witness Larkin specifies the method for calculating the "Combined API" on
649 page 7 of Schedule 1 to her direct testimony, Ameritech Illinois Exhibit 3.0. Ms.
650 Larkin recommends that this proposed API be combined by weighting the existing
651 API of each basket by the maximum allowable revenue in each basket. Ms. Larkin
652 defines the maximum allowable revenue in each basket as the existing revenue
653 multiplied by the PCI and divided by the basket API. In response to Staff Data
654 Request RFK 3, Ms. Larkin calculated the Combined API to be 81.097.

655
656 I have several concerns with the Ms. Larkin's calculation of the Combined API.
657 First, Ms. Larkin's method uses the current maximum revenue levels for the service
658 baskets in her calculation even though the Company plans to remove the majority of
659 revenue from the Carrier Basket. The Carrier Basket currently has \$ [REDACTED] in

revenue and the Company plans to remove all but \$ [REDACTED] of that revenue from the plan. This is to the advantage of the Company because the API for the Carrier Basket (69.0541) is well under the PCI (86.68). Thus, including the revenue for the services being removed in the calculation of the combined API gives more weight to the lowest of the four API figures than would be given if the services were removed, and the Combined API is reduced by more as a result.

Second, the values provided by Ms. Larkin to calculate the Combined API are incorrect. The Company attempted to use data from the most recent annual filing (from Exhibit 5 in Docket No. 00-0260) to calculate the Combined API. However, the current revenue and API figures in Exhibit 5 are significantly different than what is included in the response to Staff Data Request RFK 3. Specifically, the Company did not provide accurate figures for the current revenue or API for both the Carrier Basket and Residential Basket. Also, the Carrier Basket API is understated considerably in Ms. Larkin's testimony. As stated above, the API for the Carrier Basket is 69.0541 but Ms. Larkin used a figure of 57.62325 in her calculation of the Combined API. As a result of using the understated Carrier Basket API, the Company is able to lower the Combined API significantly.

Third, the potential impact of the Combined API could result in significant revenue increases for AI at the expense of its captive customers. Since AI's calculation of the Combined API is lower than the PCI, and the Company is seeking 15% pricing flexibility, there would be an opportunity for the Company to increase rates for

services considerably. Using the data AI provided in response to Data Request RFK 3, the Company would be allowed to increase its rates by 6.9% overall to get to the point where the API equals the PCI. Using AI's calculation of the Combined API, the revenue impact of such rate increases would be an increase of \$ [REDACTED] (6.9% * \$ [REDACTED] in revenue remaining in the plan) annually.

Q. Have you calculated a more appropriate Combined API than the Company?

A. Yes. I believe that if all services were to be combined into one basket, the Combined API and the PCI should be reset to 100. However, if the Commission feels that a Combined API needs to be developed, I believe that there are two changes that need to be made to the way that it is calculated by AI. First, the Company needs to use the correct data from Exhibit 5 of Docket No. 00-0260 for the calculation. Second, the Company needs to perform the calculation of the Combined API after its proposed service removal. As I noted previously, including the services that are to be removed from the plan in the calculation has the effect of lowering the Combined API to the Company's advantage. I have prepared Attachment 13.02 to my direct testimony to show the effect of these two changes.

Attachment 13.02 provides two tables that calculate the Combined API. Both of these tables use the same method as AI in the response to Data Request RFK 3, but using the corrected current revenue and current API values. The first table calculates the Combined API prior to the removal of services from the plan. The

705 resulting Combined API equals 83.26. Due to this API being lower than the PCI, the
706 Company would be allowed to increase annual revenue by \$ [REDACTED] using this
707 method. The second table calculates the Combined API after removal of services
708 from the plan. The resulting Combined API equals 86.15. Due to this API being
709 lower than the PCI, the Company would be allowed to increase annual revenue by
710 \$ [REDACTED] using this method. Therefore, even when using correct data, the effect
711 of the Company calculating the Combined API prior to the removal of services from
712 the plan results in the Company having the ability to increase revenues by an
713 additional \$ [REDACTED] annually.

714
715 **Q. Should the Commission adopt AI's proposal to allow for 15% pricing**
716 **flexibility?**

717
718 A. No. It is unclear how allowing 15% flexibility could benefit consumers. Such
719 flexibility would only provide the Company with the opportunity to increase rates for
720 the least price elastic services and decrease rates for the most price elastic
721 services. As was mentioned on page 20 of my testimony, the Company has
722 historically set rates to its optimal benefit. Further, AI witness Gebhardt states in his
723 direct testimony that the Company has targeted price reductions in the plan in order
724 to promote broader deployment of its services. (Ameritech Illinois Exhibit 1.0 at 14).
725 This statement can be interpreted to mean that rate reductions have been targeted
726 to price elastic services. The Company has already shown that it will act in its own

727 best interest in this plan. I see no reason why this pricing behavior will not continue
728 in the future. Pricing flexibility could exacerbate the resulting harm to consumers.

729

730 Further, this proposed pricing flexibility has anticompetitive aspects. The plan is
731 supposed to be a transitional plan towards competition. Providing the Company
732 with a large amount of freedom to price its noncompetitive services gives them less
733 of an incentive to open up their markets for competition. Further, the Company will
734 have the ability to engage in predatory pricing strategies as well.

735

736 **VI. Staff Recommendation**

737

738 **Q. Please summarize the changes to the price cap plan that you are**
739 **recommending.**

740

741 **A.** I recommend that the following changes be made to the service baskets:

742 ?? Remove access charges from the Carrier Basket.

743 ?? Move the remaining services in the Carrier Basket to the Other Services
744 Basket.

745 ?? If the Final Commission Order in ICC Docket No. 98-0860 determines that AI
746 appropriately classified its business services as competitive, then I
747 recommend that the remaining services be moved from the Business Basket
748 to the Other Services Basket.

749 ?? If the Final Commission Order in ICC Docket No. 98-0860 requires AI to
750 reclassify certain business services as noncompetitive, then I recommend
751 that these services be returned to the Business Basket intact.

752 ?? Move residence call plans from the Other Services Basket to the Residential
753 Basket.

754 ?? Reset the PCI and the APIs for the remaining baskets equal to 100.

755 ?? Give Staff more latitude in its review of AI's annual filings.

756

757 **Q. Please describe the financial impact of removing access charges and from**
758 **the price cap plan.**

759

760 A. Removing services from the plan would generally have the effect of making the plan
761 less effective. That is, as services are removed from a basket, there is less revenue
762 in the basket that can be reduced in a given annual filing. The removed services
763 would no longer be eligible for rate reductions under the plan. However, this
764 concern is not warranted because access charges are not governed by the price
765 cap plan. Also, as I noted previously, the API for the Carrier Basket is so low that
766 no rate reductions can be ordered for these services. Thus, the removal of access
767 charges from the plan would not lessen the ability of the Carrier Basket to reduce
768 revenues for services remaining in the basket.

769

770

771 **Q. Will the removal of noncompetitive services from the price cap plan**
772 **effectively create a third class of services, that is, unregulated**
773 **noncompetitive services?**

774

775 A. No. UNEs are an example of services that are noncompetitive and not subject to
776 the price cap plan. UNE rates are developed using TELRIC cost studies.
777 Historically, these rates have been established in docketed proceeding outside of
778 the price cap plan. UNEs were excluded from the price cap plan initially because

the rates for these services must be “based on cost.” (TELRIC Order at 85).

Access charges are similar to UNEs in this respect. The rates for both of the
aforementioned services are unaffected by the price cap plan.

Access charges are based on cost by the Commission Order in Docket Nos. 97-
0601/0602 (Consol.). Unlike UNE rates, one can not argue that pricing these
services at anything other than cost is in violation of the Telecommunications Act of
1996. However, these services are ordered by this Commission to be at cost
nonetheless. Any attempt to change these rates for non-cost-based reasons in an
annual filing would be in violation to the Order in ICC Docket Nos. 97-0601/0602
(Consol.).

**Q. What would be the impact of your proposed changes to the service baskets
be on the price cap plan as a whole?**

A. The answer to this question depends on the outcome of ICC Docket No. 98-0860. If
the Commission rules based on Staff’s recommendations, then there will be a
significant increase in revenue subject to the price cap plan. As was mentioned
previously, I have been unable to determine the total impact of reclassification at this
time. Otherwise, the main impact will be a decrease in revenues due to the removal
of access charges from the plan. As was mentioned above, I have calculated the

impact to be \$ [REDACTED] in revenue reductions, using the demand and rates from the year 2000 Annual Filing.

Q. How will the APIs of the service baskets be recalculated upon making your recommended changes?

A. I propose that the values of the APIs be reset to 100 as a result of restructuring the service baskets. I am also proposing that the PCI would be reset to 100. This proposal would give the newly restructured baskets the maximum capacity to affect rate changes. Using a method similar to that proposed by AI to calculate a Combined API would introduce complications, as was illustrated in my discussion of AI's proposal. Without resetting the API and PCI values, consumers would potentially face rate increases.

Q. Do you have any other recommendations for the price cap plan on a going-forward basis?

A. Yes. It would be beneficial to give Staff more latitude in its ability to review the API provided by the Company in its annual filing. The Commission currently requires the Company to provide the calculation for the API for each service basket in the annual filing. However, AI does not provide all changes to the API over the course of the year in order to determine if its calculation is appropriate. Staff has previously had

822 to ask for this information in the form of data requests. Given the brief period
823 accorded to Staff of the review of annual filings, AI's incomplete filings only serve to
824 further limit the time available to Staff to review and comment on AI's API
825 calculations.

826
827 Therefore, I recommend that the Commission take two actions to resolve this
828 problem. First, explicitly state in the Order of this docket that, at each annual filing,
829 the Company shall provide a calculation of every change to the an API between
830 annual filings for each service basket. Second, explicitly state in the Order of this
831 docket that, in cases where the Company's changes to the API values are without
832 adequate support, Staff is allowed to decide the appropriate value of the APIs.
833 Staff would be required to provide justification for its calculations of the APIs to the
834 Commission in these instances, but the Company would not be able to challenge
835 these numbers. Although this recommendation does not appear to be fair to the
836 Company, it is the only solution that I am aware of that could provide incentive for the
837 Company to file the support that is necessary for Staff to review the calculations.

838 **VI. Conclusion**

839

840 **Q. Could you please summarize your Direct Testimony?**

841

842 A. Yes. The Commission enumerated ten issues for review of the plan in Appendix A
843 of the Alt. Reg. Order. This testimony examined the issues of the Appendix
844 concerning the effectiveness of the service baskets in the plan. It was found that the
845 alternative regulation plan for AI has been effective in reducing rates for the most
846 part. With the exception of the Carrier Basket, the Company has reduced rates in
847 each of the baskets in a manner consistent with the reduction of the price cap index.
848 These reductions have been in the neighborhood of 2% annually in each of the
849 baskets for each year of the plan's existence.

850

851 There are, however, significant problems with the service baskets. A significant
852 concern is the issue of service reclassification that, although outside the scope of
853 this docket, nonetheless has a notable impact on the plan. Consumers are harmed,
854 to the extent such reclassification is improper, by price increases for these services
855 as well as the unrealized rate reduction from not having the services in the plan. As
856 a result, the Business Basket has been reduced to relative insignificance. There
857 are other problems with the service baskets as they exist today. Of particular
858 concern is the inability of the Carrier Basket to effectuate rate decreases in the plan
859 and local usage plans being improperly placed in the Other Services Basket.

860

861 AI has recommended a number of changes to the plan that are, in my opinion,
862 detrimental to customers and to potential competition. Accordingly, I have made
863 alternative recommendations that will ameliorate the problems that currently exist
864 with the service baskets. The changes I recommend are necessary for the price
865 cap plan to be effective on a going-forward basis. These changes facilitate a
866 transition to a competitive marketplace while maintaining the protections to
867 consumers of noncompetitive services in the interim.

868

869 **Q. Does this conclude your testimony?**

870

871 A. Yes.